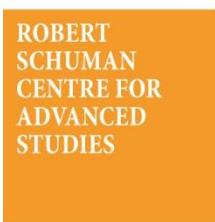




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**Liberalizing Trade in Services:
Lessons from Regional and WTO Negotiations**

Bernard M. Hoekman and Aaditya Mattoo

European University Institute
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Abstract

Liberalization of trade and investment in services through trade agreements has progressed less than trade in goods. We review the limited progress achieved to date in the WTO and major regional agreements on services and possible explanations why trade agreements have not been more effective at integrating the services markets of participating countries. We argue that the prospects for both services liberalization and welfare-enhancing regulatory reform in the context of trade agreements can be enhanced through mechanisms that enhance transparency, dialogue and cooperation between regulators, trade officials and stakeholders.

Keywords

Services regulation, trade liberalization, international negotiations, trade agreements, WTO, development assistance, aid for trade.

JEL Classification: F13

I. Introduction

The last three decades have seen the rapid internationalization of production, consumption, trade and investment in services. Cross-border trade in services stood at some US\$ 4.2 trillion in 2011, or about 20 percent of world trade. Modern information technologies allow ever more cross-border, “disembodied” trade in services to occur—call centers and other types of “business process outsourcing” being well-known examples. The rise in services trade has been supported by falling barriers to trade and investment as well as technological advances, both of which have lowered trade costs for services. However, recent World Bank research documents that barriers to trade in services in both high-income and developing countries remain high, and that emerging markets have barriers that are on average substantially higher than OECD countries (Borchert, Gootiiz and Mattoo, 2012). This helps explain why services are on the negotiating table in the WTO and in an increasing number of preferential trade agreements (PTAs).

It is in any country’s interest to adopt policies that increase the efficiency of domestic services markets but reform may be impeded by vested interests which benefit from protection. In principle, international trade negotiations can help overcome opposition to reform from import-competing interests by mobilizing domestic political support for reforms from exporting interests and thus achieve a reciprocal exchange of liberalization commitments. While a trade agreement will presumably generate gains in terms of greater exports, more important from an economy-wide perspective are the benefits that come from firms and households having access to a greater variety of lower cost, higher quality services.¹

However, in practice, very little progress has been made to date in the WTO either to expand the coverage of services disciplines much beyond what was negotiated in the Uruguay Round in 1994 or to generate any real liberalization of services markets. The same is true for most preferential trade agreements (PTAs): despite the proliferation of regional agreements covering services trade, most do relatively little to open services markets. Moreover, so far there are no bilateral PTAs between any of the major players – Brazil, China, EU, India, Japan, and the US – implying that when it comes to international disciplines on the services trade policies of these entities it is WTO commitments that define the rules of the game.

In this paper we argue that services raise new challenges and issues for trade agreements in that a major factor underpinning the limited progress to date is fear that governments may be deprived of the freedom to regulate and worries that regulatory frameworks are inadequate to manage unrestricted entry and competition. In many instances adequate regulation will be a precondition for liberalization. The implication is that market access negotiations must be complemented by processes that focus on improving services regulation and regulatory institutions. Trade negotiators do not generally concern themselves about the adequacy of national regulation and institutions, or the need for international regulatory cooperation where there are regulatory externalities. Our premise is that all countries would participate more meaningfully in negotiations if they knew that the regulatory preconditions for benefiting from making liberalizing commitments were in place. Addressing regulatory issues is a major challenge as it entails a need for coordination and communication within government and across stakeholders that far exceeds what has traditionally been required to negotiate agreements to liberalize trade in goods.

The paper is organized as follows. Section II reviews where matters stand in the WTO and in major PTAs on services. Section III reviews several potential explanations for the limited progress that has been achieved through trade agreements. Section IV discusses possible mechanisms to improve both

¹ Francois and Hoekman (2010) survey the recent empirical literature assessing the effects of greater trade and competition on productivity of firms that use services as inputs.

services regulation and the prospects for more extensive market access commitments. Section V briefly discusses some implications for cooperation on services trade at the WTO. Section VI concludes.

II. Services trade agreements: The state of play

The disciplines on policies affecting trade in services that are embodied in trade agreements differ from those for trade in goods in important ways. Because international transactions in services often require face-to-face contact between consumers and providers, services agreements generally cover not just cross-border trade but also exchanges that takes place through the cross-border movement of consumers and suppliers (both temporary presence of individuals and longer-term via FDI). Thus, the definition of trade in services in the WTO and in PTA typically covers the following modes of supply:

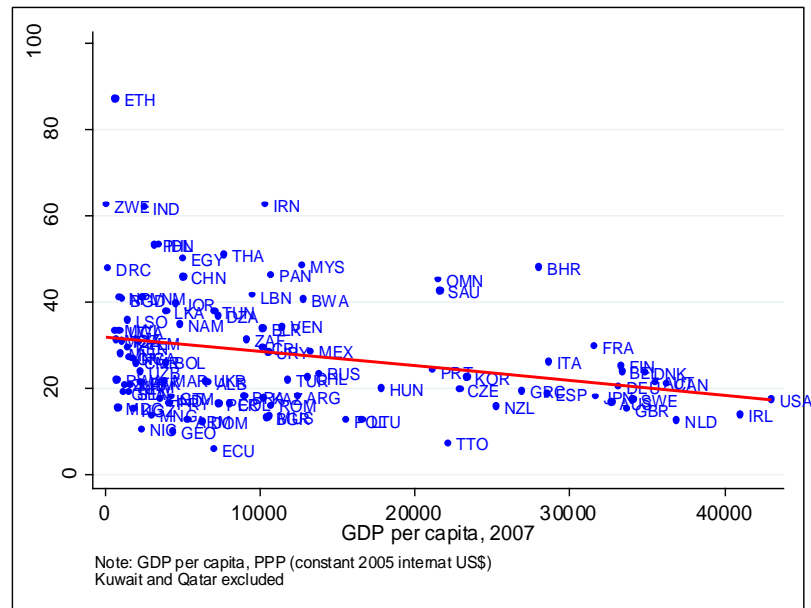
- Mode 1: supply of a service from the territory of one Member into that of another Member, i.e., supplier and consumer interact across distance (cross-border trade).
- Mode 2: consumption of a service by consumers of one Member who have moved into the territory of the supplying Member (consumption abroad).
- Mode 3: services are provided by foreign suppliers that are commercially established in the territory of another Member (commercial presence).
- Mode 4: services are supplied by foreign natural persons, either employed or self-employed, who currently stay in the territory of another Member (presence of natural persons).

The Uruguay Round coverage of sector-specific commitments on market access and national treatment was limited—in practice they implied that the GATS was an instrument through which a subset of policies that had already been implemented by Members on a unilateral basis were “locked-in”. For many developing countries the coverage of specific commitments is below 50 percent of all services and modes of supply (Adlung and Roy 2005).

GATS commitments do not provide a full picture of applied policies, making it only possible to compare levels/coverage of commitments across countries.² Until very recently it was therefore not possible to assess the extent to which commitments implied a locking-in of applied policies. A new World Bank database on services trade barriers now allows such an assessment to be made. It reveals that applied policies in some sectors are much more restrictive than in others, with mode 4 being the least open. The policy commitments (bindings) made in the GATS during the Uruguay Round are on average 2.3 times more restrictive than currently applied policies – i.e., countries could more than double their trade barriers without violating their commitments (Gootiiz and Mattoo, 2009). Borchert, Gootiiz and Mattoo (2012) analyze available public information on the services offers by 62 WTO members that had been put on the table through 2008 and conclude they would improve on existing GATS commitments by only about 10 percent. As a result, GATS commitments on average would remain twice as restrictive as actual policies—implying great scope for WTO members to increase the restrictiveness of prevailing policies if they desire to.

² There is no requirement to report on policies affecting sectors that are not scheduled.

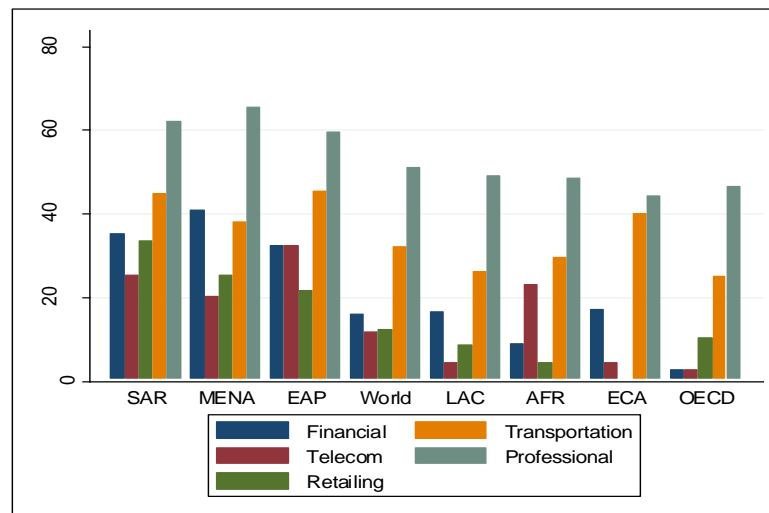
Figure 1: Restrictiveness of Services Trade Policies



Source: Borchert, Gootiiz and Mattoo (2012).

Figure 1 is a scatter diagram using this database where the location of each country reflects the overall restrictiveness of its services trade policies and its per capita income. High-income countries are clustered at the bottom-right, showing that they are quite open overall. There is much more variation in the restrictiveness of services policies for low-income countries. Some developing countries, like Ecuador, Ghana, Nigeria, Senegal, and Mongolia are remarkably open, while some of the most restrictive policies today are visible in the fast growing economies of Asia, as well as in the Middle East. Figure 2 uses the same data but focuses on average levels of restrictiveness by sector and geographic region. There is a lot of variation across sectors, with some subject to high discriminatory barriers in all regions (transport and professional services) and others that are much more restricted in some countries than others. Financial services and retail distribution tend to be much more open to foreign competition in high income countries.

Figure 2: Restrictiveness of Services Trade Policies by Sector (102 countries)



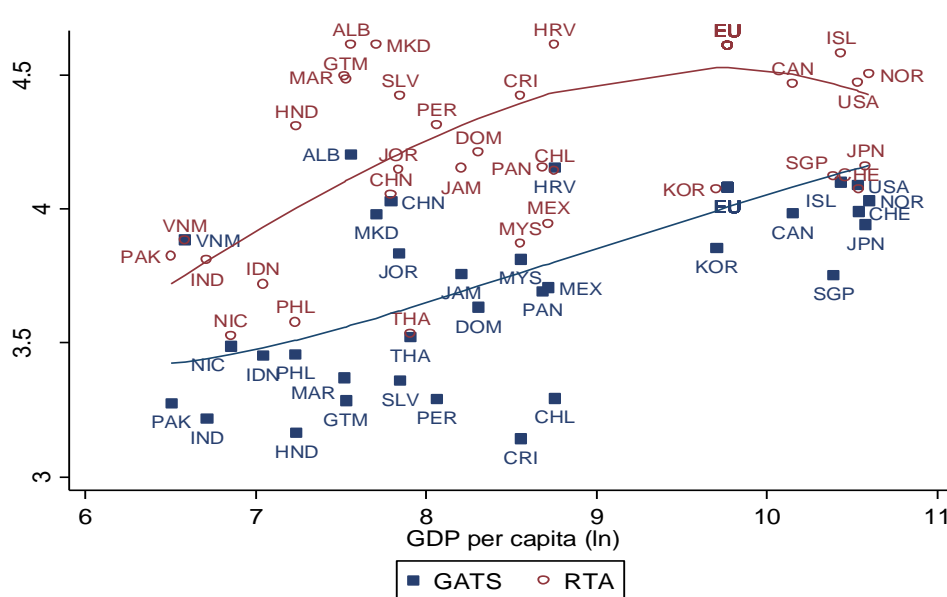
Source: Borchert, Gootiiz and Mattoo (2012).

Services in preferential trade agreements

Most PTAs negotiated since the early 1990s include provisions on services. Although many early PTAs do not go much beyond the GATS, more recent vintage agreements tend to have a higher level of ambition when measured by sectoral coverage. Assessments by Roy, Marchetti and Lim (2007), Marchetti and Roy (2008), Fink and Jansen (2009), and Miroudot, Sauvage and Sudreau (2010) find that many of the PTAs reported to the WTO since 2000 have a sectoral coverage that substantially exceeds the commitments the countries involved made in the GATS. Figure 3, taken from Van der Marel and Miroudot (2012), illustrates this by plotting the average number of sectors subject to commitments in PTAs against each PTA member’s commitments in the GATS. Fink and Jansen (2009) note that more commitments are made in sectors where countries have also made more extensive commitments in the GATS. Sensitive sectors such as health, transport and the movement of natural service suppliers (mode 4) tend to be subject to the fewest commitments.

The substantive disciplines (rules) that are included in many PTAs are similar to those in the GATS, i.e., the depth of the associated commitments often does not go much beyond what PTA members committed to under the WTO (Roy et al, 2007; Fink and Jansen, 2009). In areas where there are no WTO disciplines, there often tends not to be rules in PTAs either—examples are safeguard provisions, rules on subsidies and domestic regulation (Horn, Mavroidis and Sapir, 2010). Mattoo and Sauvé (2011) conclude that in these policy areas it has proven to be no easier for governments to agree to common rules and disciplines than in the WTO/GATS context; indeed, they argue that in a number of dimensions discussions and proposals put forward in the GATS and Doha Round context on domestic regulation of services go beyond what is found in most PTAs.

Figure 3. Sectoral coverage: GATS vs. PTA averages



Source: Van der Marel and Miroudot (2012).

Two important exceptions are investment protection and public procurement. Several PTAs have disciplines on investment protection and some even provide for arbitration in the case of investor-state disputes. Often these are general and not services-specific, but services are covered. The same is true for procurement disciplines: if included in PTAs, both goods and services procurement will usually be covered (see e.g. Schott et al. (2012) on the Korea-US FTA). These two policy areas are not covered by general WTO disciplines. The WTO deals with investment policies only through the GATS

(insofar as a Member decides to make mode 3 commitments for a service sector), while commitments on government procurement only apply if countries decide to sign the plurilateral Agreement on Government Procurement (GPA).

Many of the PTAs that include chapters on government procurement policies simply reflect the prevailing status quo or only have best endeavor-type language.³ However, some recent agreements include enforceable commitments to remove discrimination; to use new technologies such as electronic procurement, and provisions to create institutions to implement procurement reforms. An example is the creation of a Single Government Procurement Market in the New Zealand-Singapore Closer Economic Partnership Agreement through implementation of the APEC Non-Binding Principles on Government Procurement (which include transparency, value for money, open and effective competition, fair dealing, accountability and due process, and non-discrimination). The two countries commit to ensuring that suppliers from either country can compete on an equal and transparent basis for government contracts and agreed to establish a mechanism to work towards achieving the greatest possible consistency in contractual, technical and performance standards and specifications. This example illustrates that it is possible to achieve far-reaching integration of markets. PTAs that include ambitious procurement liberalization suggest that complementary measures may be important in supporting international cooperation. Recent agreements in Asia emulate the Association Agreements that the EU has concluded with neighboring states in that significant attention is paid to supporting efforts to build state institutions and expertise. Provisions in many North-South agreements aim at fostering cooperation, information exchange, and training of staff strengthen the resources and the authority of state bodies. The newer PTAs also often establish future timetables for deliberation and review processes. What this suggests is that binding commitments on market access (non-discrimination) may be conditional on governments perceiving that the preconditions for effective implementation and “ownership” of the procurement disciplines – including by civil society and business – have been satisfied. This in turn can be pursued through technical assistance and capacity building and sequenced approach to implementation of specific commitments. Rather than regard trade agreements as an opportunity to generate one-off market access reforms, the review provisions that are found in some of the newer PTAs suggest a more dynamic approach is both feasible and desirable, one that revolves around helping partner countries achieve development objectives.

An important determinant of the economic effects of any PTA is whether and to what extent it discriminates against non-members. For the trading system as a whole, the degree to which all PTAs generate discrimination is critical, as a central principle of the WTO is the MFN rule. In the case of PTAs liberalizing trade in goods such discrimination occurs by design—tariff reductions are applied on a preferential basis and as a result give rise to trade diversion costs. In the case of services PTAs such effects need not occur because many policies affecting services provision or consumption in a market do not differentiate between foreign providers on the basis of nationality or origin.

Whether a preference can be granted on a particular mode, depends on the instrument of protection that a country has in place. For instance where a country imposes a quantitative restriction on services output or on the number of service providers, it could allocate a larger proportion of the quota (e.g. through discretionary licensing) to a preferred source. Examples of the former can be found in cross-border trade (mode 1) in air, road and maritime transport, where many countries allocate freight and passenger quotas on a preferential basis, and in audiovisual services, where preferential quotas exist on airtime allocated to foreign programs. Examples of the latter are restrictions on commercial presence (mode 3), such as on the number of telecommunications firms and banks, and on the presence of natural persons (mode 4), such as professionals that are allowed to operate.

³ The following paragraph draws on Evenett and Hoekman (2012).

A country could also relax restrictions on commercial presence (mode 3) pertaining to foreign ownership, type of legal entity, branching rights, etc., on a preferential basis. For example, under NAFTA, Mexico eliminated ownership restrictions on financial institutions established in Canada and the United States, but for a certain period maintained restrictions on financial institutions based outside these countries. In the Australia-United States free trade agreement, Australia lifted the requirement of Foreign Investment Review Board screening on inward foreign direct investment in non-sensitive sectors for the United States alone (Dee and Findlay, 2007).

There could be discrimination through taxes and subsidies. In many countries, all firms established in a country are assured of national treatment, i.e. there is no discrimination against such firms even if they are foreign-owned - so there is limited scope for preferential treatment of some foreign providers post-establishment. Far more feasible is preferential treatment, especially on modes 3 and 4, through domestic regulations pertaining to technical regulations, licensing and qualification requirements. Many countries impose qualification and licensing requirements on foreign providers that are not necessary to achieve regulatory objectives. Where these are waived only for some of the foreign providers who deserve the benefit, preferences result. Regulatory preferences also arise in other sectors, ranging from transport to financial services. For instance, owing to the reciprocal recognition of the proof of solvency between the European Union and Switzerland, insurance companies that have their principal place of business in the territory of one of the contracting parties are not obliged to localize funds to a significant extent. The United States agreement with Canada eliminates the need for chartered accountants trained in these countries to duplicate all steps in the licensing process, and provides for abbreviated examination requirements.

Despite the feasibility of preferences, and the few examples of preferential access actually being granted, most studies suggest that the extent of preferential access is limited. Fink and Jansen (2009) argue that even when PTAs grant nominal preferential access, the rules of origin for services that are contained in many PTAs are mostly liberal, in that PTA benefits extend to non-member firms that are established (have a commercial presence) and/or have substantial business operations in a PTA member. VanGrasstek (2011) looks carefully at the PTAs of four countries/blocs (Chile, the EU, Japan and the US) and concludes that the PTAs signed by these countries offer little in the way of preferential treatment to partners and largely imply a “locking-in” of already prevailing policies. Other studies also suggest that the extent of discrimination associated with services PTAs is small (Miroudot et al, 2010; Mattoo and Sauv e, 2011).

The empirical assessments of PTAs briefly summarized above suggest that while many recent PTAs go significantly beyond what countries have been willing to do in the GATS in terms of the sector coverage of market access commitments, they have done little if measured on the basis of actual liberalization of trade and investment restrictions or the extent to which countries have agreed to change their regulatory policies. Insofar as liberalization of specific sectors was driven by a PTA, this is mostly limited to so-called North-South PTAs involving either the EU or US on one side and a small developing country (countries) on the other. In such agreements the large players do not change their policies, but their small trading partners may do so, in the process going beyond what they have been willing to commit to in the WTO/GATS (Marchetti and Roy, 2008). As discussed in the next section, this pattern can be explained by asymmetries in size, but other factors also play a role, including the underlying motivations for a PTA. A key policy issue that arises if PTAs are between countries that are very dissimilar is whether any associated market opening and/or policy/regulatory reform is welfare enhancing for the countries that have undertaken commitments to this effect. This can only be assessed on a case-by-case basis, and any such assessments will of course depend on the criteria that are employed.

A unique feature of some PTAs that distinguish them from the WTO is the incorporation of nonbinding “soft law” forms of cooperation. For example, APEC economies have pursued a much looser model of cooperation (Elek, 1998). Participants are expected to adhere to an evolving set of guiding principles which define the objectives and means of cooperation, including those set out in the

Seoul APEC Declaration and the Osaka Action Agenda. On the other hand, these principles are not legally binding. APEC governments are free to set their own schedules for dismantling border barriers and sub-groups of APEC economies are free to enter into other cooperative arrangements to facilitate trade or investment ahead of others.

Often cooperation takes the form of provisions to provide technical and other forms of assistance, and the establishment of mechanisms for the exchange of information, interactions between business associations/investors/civil society groups, and non-economic forms of cooperation (e.g., student or cultural exchanges). PTAs often also create a variety of official bodies that are tasked with implementation of the agreement in specific areas and that can act as mechanisms through which the regulators and other officials from the participating countries establish working relationships. As discussed further below, one lesson is that the prospects for PTAs to enhance the welfare of developing country signatories are improved if the focus extends beyond market access. Including complementary measures that aim at improving the domestic regulatory environment; bolstering related institutions; the provision of technical and financial assistance; and active engagement by the private sector in surveillance and enforcement of the PTA is equally if not more important (Hoekman, 2011a).

To sum up, even though recent PTAs have wider sectoral coverage of services, they do not appear to have induced significant market opening. There are certainly exceptions – such as the liberalization of telecommunications in several Central American countries as a result of the US-CAFTA agreement – but there is also evidence that many PTAs have less than GATS commitments. Indeed, Adlung and Morrison (2010) argue there are GATS-*minus* elements in about 80 percent of all PTAs. The benefits of PTAs relative to the GATS may be more in the area of improved cooperation and communication between officials on policies affecting the sectors and activities that are covered by the PTAs.

III. Potential explanations for limited coverage of services in trade agreements

In the case of goods trade, there is an extensive literature that identifies several possible motivations for governments to engage in trade negotiations. This includes the terms of trade (market access) rationale: countries negotiate away the negative spillovers that are created by the imposition of trade restrictions. Trade agreements can also help governments implement reforms that are opposed by politically powerful vested interests. This is because international agreements offer a way for breaking domestic deadlocks by mobilizing export groups to support reform, as mentioned above. Another strand of economic literature argues that trade agreements offer a commitment mechanism to governments. By committing to certain rules that bind policies, i.e., “policy reform anchors,” government may use agreements to make domestic reforms more credible.

In principle these rationales should carry over to services trade liberalization. The puzzle is that in practice they do not appear to be as strong as has historically been the case for trade in goods. One potential explanation is that there is less need in the services context for traditional reciprocity-driven market access negotiations (Hoekman, 2008). Insofar as inefficient service industries will generate costs for all downstream sectors, there is likely to be more pressure for unilateral reform than is the case for a tariff that protects a specific goods industry (as these have fewer economy-wide repercussions). In practice most reforms that have been implemented by both developed and developing countries have been autonomous. While this may help explain the significant reform in services since the late 1980s in most countries, barriers to trade and investment continue to characterize many service industries in both developed and developing countries.

Another potential reason why reciprocity may be less powerful in supporting reforms is that services exporters often face contrasting conditions of access: markets that are already open (and required no effort by firms to open) and markets that are almost irremediably closed. Thus, cross-border trade in services (e.g., business process outsourcing) or trade in tourism – two activities where

many developing countries are net exporters – are generally not affected by restrictive policies. Conversely a large set of developing countries confront particularly high barriers for the one mode that is of export relevance to them – mode 4 – which in practice is for all intents and purposes not on the table in (most) trade agreements. A consequence is that the standard political economy of trade negotiation may break down: domestic opposition to reform and liberalization by incumbents cannot be counterbalanced by export interests seeking better access to foreign services markets. The prospective additional profits associated with better access to foreign markets for exporting firms may be much smaller than the rents/excess profits that are captured by sheltered incumbents in the countries concerned. A related argument is that reciprocity may be less powerful in services because a policy reform that is made at the request of a trading partner is often automatically going to be of benefit to all other countries. This is because services policies often do not differentiate between the origin of firms operating on a market.

In our view an important reason for slow progress on negotiating services policy reform commitments are concerns about the realization of regulatory and non-economic objectives. Liberalization of services markets needs to be complemented by effective regulatory standards and implementing bodies. Regulation in services is pervasive and is driven by both efficiency and equity concerns (Mattoo et al., 2008). The characteristics of many services give rise to market failures. For example, the existence of natural monopoly or oligopoly is a feature of “infrastructure services” that require specialized distribution networks: roads and railways, airports, or cables and satellites for telecommunications. Regulation of the owners/operators of the networks can then enhance efficiency by preventing prohibitive charges for access or interconnection to essential facilities, such as their established networks. Problems of asymmetric information are frequent in the services context. Buyers (consumers) confront serious hurdles in assessing the quality of service providers – e.g., the competence of professionals such as doctors and lawyers, the safety of transport services, or the soundness of banks and insurance companies. The regulation of entry and operations in a sector can increase welfare. Governments may also regulate to achieve equity objectives – e.g., ensuring access to services for disadvantaged groups.

Trade agreements generally do not constrain domestic regulation beyond general principles such as nondiscrimination and transparency provisions. While they may do little to attenuate a government’s “policy space”, they often also do little if anything to help governments determine whether they have adequate national regulation in place and whether there is a downside risk associated with making specific commitments. An example is a commitment to allow foreign banks to enter as branches. Branch banking implies that the capital adequacy standards of the home country apply and that there may not be any restrictions on the ability of the parent bank to transfer capital out of the market in which it establishes branches. If a government is concerned about this it could require foreign banks to establish local subsidiaries that must satisfy local capital adequacy requirements. But this presupposes that there is effective regulation and an effective regulator that considers the potential effects of different forms of liberalization.

Another example is when there are significant rents associated with a certain policies. Regulatory agencies may argue that it is better that these accrue to domestic agents than to foreign firms, even if the latter are more efficient providers of services. The name of the game in trade negotiations is market access: this may easily result in a transfer of rents from local firms to foreign ones if the regulatory regime is not one that ensures markets are contestable. The implication is that broader regulatory reform is in many cases needed to ensure that welfare increases after liberalization. In general, improved prudential and pro-competitive regulation will be necessary to deliver the full benefits of liberalization in sectors such as financial services; basic telecommunications and other network-based services. Thus, attention should focus on strengthening and maintaining a robust

capacity to identify, understand and design the *domestic* regulatory reforms that are needed to enhance the efficiency of services sectors.⁴

IV. Addressing regulatory concerns and constraints

Given the importance of regulation as a source of market segmentation, cooperation on regulatory matters is needed for trade agreements to do more than be a mechanism to lock-in applied policies and “harvest” unilateral actions by governments to open markets. One dimension of such cooperation is international assistance for *national* regulatory reform and strengthening implementing institutions so as to increase the prospects of achieving efficiency and equity objectives. This is a process that takes time and that will benefit substantially from information on the approaches and experiences of other countries that have (had) similar challenges. There is not necessarily any regulatory “best practice” for a sector or cluster of activities—in many cases there will be many options and countries need to figure out the approach most appropriate to their circumstances and needs. Once a reform path has been defined, implementation could be assisted by external assistance from high-income partners in North-South PTAs or development agencies as part of the multilateral “aid for trade” initiative. International dialogue and exchange of information and experiences – as is done through APEC – is another option. While APEC has often been criticized for being a “talking shop” the process has been effective in facilitating learning about country experiences and building trust among governments and regulators from participating countries. Better regulation will often be a precondition for action to open markets to greater competition, as well as for greater trade in instances where recognition of, or convergence in, regulatory norms is required to permit foreign firms to contest the domestic market.⁵

Another type of cooperation is *between* regulators and is explicitly focused on expanding market access opportunities: aiming to address regulatory externalities that impede greater trade in services. The types of externalities that may arise will differ depending on the service activity. More cooperation on prudential regulation may be a precondition for trade in financial services and in information-based services to occur—for example, regulators may need to converge on a set of regulatory or data protection standards and establish that such standards are enforced. Competition agencies may need to have assurances that pro-competitive regulations apply in partner markets to ensure that gains from liberalization are not appropriated by international oligopolies. Particularly important is cooperation between regulatory agencies in host and source countries to allow greater temporary cross-border movement of natural persons that provide services—the experience of a number of successful bilateral labor agreements demonstrates that this is a precondition for arrangements that expand the “circular flow” of people. Mutual recognition of licenses and certification will often be another part of the equation.

Does the sequence in which regulatory conditions are fulfilled and markets liberalized matter? Or should countries simply “do what you can do when you can do it”? Sometimes there is no good reason to hold back on liberalization even when regulatory reforms and access widening policies take time to implement. This is true for reforms that are “additive” in that the benefit from trade reform is independent of the benefit from domestic reforms and each can be undertaken separately. Thus, for example, the powerful growth of mobile telephony even in institutionally weak countries like Somalia suggests that there is no economic reason to wait to liberalize until a universal access policy is put in place say in telecommunications. In other cases reforms are “multiplicative” in that a country would benefit more from trade reform if domestic reforms were also implemented (and vice versa), but the order in which the two are implemented does not matter. Thus, regulatory improvements and competition in transport are mutually beneficial but the sequence is probably not critical.

⁴ See for example Mattoo and Payton (2007) for specific examples in a low-income country.

⁵ But as Dee and Findlay (2007) note, “Given the relatively high resource cost of making and implementing good policy, it is unlikely that all countries can or should move immediately to ‘world’s best practice’ in all regulatory areas.”

However, in a number of situations, “sequences matter” in that if a country implements trade reform before the necessary domestic reform, then the long-term payoffs will be lower than if the opposite sequence had been followed. This can be for both economic and political reasons. In these situations, if the complementary reform cannot be implemented instantaneously, then there is a case for gradual liberalization. For example, in countries like Zambia and South Africa, the failure to introduce full competition in a sector such as telecommunications made it much more difficult to implement effective regulation because of the excessive economic and political power of a monopolistic incumbent. In other sectors the problem has rather been too much competition too early leading to a form of “regulatory overshooting”. For example, allowing new entry in banking without creating a mechanism to sift the sound institutions from the dubious led to disruptions that have had a durable effect on the development of the financial sector in many countries: the once-bitten depositor is skeptical of the benefits of banking and the once-bitten central bank excessively prudent with stability the main concern. The result has been the implementation of excessively stringent regulation that has itself become an impediment to access.

IV.1 Fora for learning and communication: “knowledge platforms”

There are two specific dimensions to the broad challenge of *national* regulatory cooperation and services policy reform: (i) addressing knowledge gaps – increasing information on regulatory experiences and impacts and identifying alternative options/good practices; and (ii) identifying the impact of – and the options for dealing with – the political economy constraints that impede the implementation of welfare improving reforms.

A number of analysts including Geza Feketekuty (2010), one of the “fathers” of the GATS, have suggested that efforts to improve market access opportunities need to be complemented by other approaches. Feketekuty argues for a mechanism to share experiences regarding services regulation and reform, to generate information on the substance of regulation and enforcement in different countries, on what works and why, and what did/does not. An important function of such a mechanism is to bring together sectoral regulators and experts with trade officials and specialists. The former often do not think about trade and the trade implications of sectoral regulation, but are the “owners” of the policies that affect trade opportunities.

The negotiation literature stresses that negotiators need to learn about the preferences and interests of other parties, as well as their own, and this is a process that takes time. Negotiations invariably involve a complex process of interaction between domestic groups that result in an understanding of negotiating objectives/priorities. Learning is critical when it comes to the substance of policy rules—officials and stakeholders need to understand what the implications are of a given proposed rule and how it will impact on the economy. Establishment of “knowledge platforms” – fora aimed at fostering a substantive, evidence/analysis-based discussion of the impacts of sector-specific regulatory policies – could help build a common understanding of where there are large potential gains from opening markets to greater competition, the preconditions for realizing such gains, and options to address possible negative distributional consequences of policy reforms. Generating information on the impact and experience with reform programs that were pursued in other countries could help governments both assess prevailing policies and institutions in their own nations, and identify policy reform options.

Such fora could fulfill a number of roles.

- First, a mechanism through which information is generated on current services activity, prices and trade flows and prevailing regulatory policies. Better information on services policies and performance would help facilitate broad based discussion on what priority sectors are and where the key regulatory problems lie.
- Second, enhance knowledge of regulatory experiences and impacts in other countries, in the process identifying alternative options/good practices through collection and sharing of information on the factors underlying successful efforts to expand trade in services and the

complementary policies that can be used to address market failures and distributional concerns. Information and experiences from a range of countries can help ensure that regulations and standards that are adopted reflect local conditions and capacities for effective implementation.

- Third, by bringing together representatives of a range of countries (officials, regulators, private services suppliers) governments can discuss and learn about alternative approaches that have been pursued in practice to address the political economy constraints that may impede regulatory reform and constrain efforts to reduce barriers against foreign providers of services.

Any mechanism to identify good practices in regulation and services policies must be broad-based and tap into knowledge across the globe for a specific sector or issue, including both developing and developed countries. International sectoral organizations such as the ITU (for ICT/telecoms); the IMF/BIS, IASB, IOSCO, and the Berne Union (for financial sector-related standards/regulation), the IOM/ILO (for migration and cross-border movement of people); and networks of sectoral regulators and related institutions (such as the International Competition Network) could be the focal points for specific activities. The same applies to entities such as APEC and the OECD, UNCTAD and WTO secretariats and business associations such as the Coalition of Services Industries that exist in a number of countries.

In practice knowledge platforms may best be designed on a regional basis, linked to PTAs and regional institutions (such as regional development banks). Many PTAs include provisions calling for the creation of joint commissions and committees to interact on a given subject matter covered by the PTA, as well as periodic high-level joint meetings of senior officials and Ministers. But no PTAs to our knowledge has implemented what is being proposed here.⁶

IV.2 International regulatory cooperation

As noted above, facilitating regulatory cooperation could help deal with apprehensions about liberalization on all modes. For example, in financial services, confidence in cooperation by the home country regulator could lead to openness to both commercial presence and cross-border trade. Similarly, in international transport services, confidence in the enforcement of home-country competition law may increase the willingness to liberalize in importing countries (Hoekman, Mattoo and Sapir, 2007). This is the case in particular if trade agreements are to become vehicles to facilitate the movement of natural persons (services providers). The assumption of obligations by source countries is a key element of regional mechanisms (e.g. APEC) that have facilitated mobility of skilled service workers, and bilateral labor agreements (e.g. between Spain and Ecuador, Canada and the Caribbean, Germany and Eastern Europe) that have to a limited extent improved access for the unskilled. Source country obligations may include pre-movement screening and selection, accepting and facilitating return, and commitments to combat illegal migration. In effect, cooperation by the source can help address security concerns, ensure temporariness and prevent illegal labor flows in a way that a host nation is incapable of accomplishing alone.

Mutual recognition or acceptance of the regulatory standards and norms prevailing in partner countries can be a key driver of deeper integration of services markets. As is well known, it has generally proven very difficult for regulatory authorities, civil society and the business community to make rapid progress in agreeing that standards are “equivalent” and in practice a minimum level of convergence in the substance of regulatory norms will be required. The benefits of eliminating policy differences through harmonization depend on the prospects of creating a truly integrated market, which in turn is a function of the degree of similarity of the countries that are negotiating or engaged in a PTA (Mattoo and Sauv e, 2011). The more similar—in terms of per capita incomes, economic and governance structures, legal regimes, etc.—the more difficult it is likely to be for one country to

⁶ The EU is of course *sui generis* given its supra-national nature.

accept to change its regulatory norms and approaches to converge with those prevailing in a partner country. But at the same time if the countries are not very different in terms of per capita income and “structural features” the easier in principle it should be to agree to accept the standards of the other.

For countries that are very different – as is the case in many North-South PTAs – it will be much more difficult if not impossible to move down the path of mutual recognition as high-income partners will not accept dilution of their norms, whereas adoption of these norms may not necessarily increase the welfare of the low-income country partner. The latter therefore must balance the costs associated with raising its regulatory standards to the level of the high-income partner against the benefits that are associated with the greater trade opportunities this will generate. In practice the trade-off may not be stark insofar as the process of convergence helps a country attain better economic outcomes. Whatever the case may be, regulatory cooperation is a precondition for greater trade in services to occur.

IV.3 Aid-for-services trade to support implementation

An effective knowledge platform will identify specific areas for policy reform and ways in which regulatory institutions and enforcement capacity need to be strengthened for liberalization to be beneficial. As mentioned, the main focus of a platform or forum is not services liberalization per se, but to focus on where it is necessary/desirable to bolster and improve *national* services regulation. A platform could however also be a vehicle to support the international regulatory cooperation that is needed to allow greater trade in services to occur.

In many cases implementation of PTAs will involve a need for investments: in training, in infrastructure, data and information systems, etc. Low-income countries may not have the resources required or may have more urgent financing needs. Incorporating specific commitments and mechanisms through which a government (and stakeholders) can obtain the necessary technical and financial support should be a core feature of trade agreements that seek to achieve deeper integration of the economies of participating countries. This applies both to binding (enforceable) market access-related commitments and to the soft law forms of cooperation discussed above. Many North-South PTAs do too little to complement market access commitments with adequate and effective aid for trade in services.

Such assistance will generally not be available in the context of PTAs between developing countries. The multilateral aid for trade initiative that was launched at the 2005 WTO ministerial in Hong Kong provides a mechanism through which low-income developing country governments can obtain financial and technical assistance to implement regulatory improvements.⁷ To date most aid for trade assistance has focused on infrastructure investments and trade facilitation – not on regulation or service sector policies. There is no reason why aid for trade would not be provided for services policy reforms if these are identified as priorities by developing country governments (Hoekman, Mattoo and Sapir, 2007).

⁷ Although the Aid for Trade initiative is not not part of a quid pro quo for developing countries to make commitments, the initiative was in part driven by a recognition that not enough attention had been given to effectively assisting countries to benefit from market access opportunities created by WTO commitments. See Hoekman (2011b).

V. Services PTAs and the WTO

The idea is now gaining ground that the Trans-Pacific Partnership with the US in the lead and based on the idea of open regionalism could be an alternative to the multilateralism of the WTO and also as the best way of engaging China on trade issues.⁸ Similarly, with the prospects for a near term conclusion of the Doha Round services negotiations having become dim, some WTO members have suggested that one way forward is for subsets of the membership to negotiate a plurilateral agreement under WTO auspices.⁹ The goal of the group is to develop an International Services Agreement (ISA) with new rules governing trade and investment in services and deeper and wider commitments on market access and national treatment. . The group has not yet decided whether any negotiated liberalization or disciplines would be implemented on an MFN or conditional MFN basis. Schott et al. (2012) argue that “Conditional MFN treatment may be the wiser choice in this agreement considering the fact that several important countries have not yet agreed to participate in the ISA and would be ‘free riders’ on the prospective liberalization if the accord is implemented on an MFN basis.” In fact, a number of WTO members have indicated that they will oppose the incorporation of a plurilateral services agreement into the WTO, implying that negotiation of PTAs will be the only alternative available to WTO members seeking to cooperate on services trade and investment policies.

The problem with the plurilateral approach is that countries like Brazil, China and India would never agree to just fall in line with rules in the negotiation of which they have not participated. Worse, TPP could also provoke these countries into playing the regionalism game in a way that could fundamentally fragment the trading system. A better way of keeping these countries anchored in the multilateral system would be for their trading partners to say that “not only in our dealings with you but also amongst ourselves, we will embrace multilateralism.” This would signal a belief in the intrinsic worth of multilateralism rather than just as an instrument to contain countries like China. One goal of such restraint today would be to prevent a dominant China tomorrow from pursuing preferential arrangements tomorrow that disadvantage excluded countries.

Meanwhile, the WTO can do much to provide its members with information on what is being done in the PTA context and to provide a forum in which members can discuss and learn from PTA experiences. The WTO can do much more to bring together regulators, trade officials, the business community, and other stakeholders to identify “good practices” that facilitate trade without detracting from the achievement of regulatory and social objectives. Instituting a parallel process that does not involve negotiations but that instead focuses on the substance of regulation (or the effects of a lack of appropriate regulation) could help countries improve regulatory outcomes and facilitate an expansion in trade. Creating such mechanisms for exchange and learning can help prepare the ground for future negotiations on services.

⁸ The TPP negotiations began in March 2010 and currently involve nine countries: Australia, Brunei, Chile, Malaysia, New Zealand, Peru, Singapore, the United States, and Vietnam. Canada and Mexico were invited to join the talks in late 2012; Japan and South Korea may do so in 2013. See Schott et al. 2012.

⁹ The group now includes Australia, Canada, Chile, Colombia, Costa Rica, the European Union, Hong Kong, Israel, Japan, Mexico, New Zealand, Norway, Pakistan, Peru, Singapore, South Korea, Switzerland, Taiwan, Turkey, and the United States. See Hufbauer, Jensen, and Stephenson (2012).

VI. Concluding remarks

Services account for more than half of the GDP of almost all countries, and more than 75 percent in high-income countries. They are critical determinants of the competitiveness of firms in any country, no matter what its per capita income is. There is great scope to expand trade in services: the fact that global cross-border trade in services is just 20 percent of all trade is not just a result of the fact that provision of many services requires a physical presence in a market. The low share of services is in part the direct result of high barriers to trade and investment. Trade agreements offer an instrument to reduce such barriers.

WTO negotiations on trade in services have not made much progress. The PTAs that have been negotiated in the last 15 years or so frequently cover substantially more service sectors and activities, but the extent to which they result in the actual reduction of barriers to trade is often limited. Negotiating the liberalization of services is complicated because the policies that restrict trade and investment and segment markets tend to be regulatory in nature. Significant movement in the direction of liberalization of applied policies will often not be possible for many countries in the near term given the great diversity in regulation and regulatory capacity. In practice the process of learning, policy and regulatory reform, and strengthening of implementing bodies that is required will take time.

For trade agreements to become more effective instruments to open services markets to greater competition the focus needs to go beyond market access negotiations. A concerted effort is also needed by governments to strengthen and improve service sector regulation and implementing institutions, as well as to cooperate with each other where there are significant regulatory externalities. Much of what remains to be done to remove barriers to trade in services in many developing countries will be conditional on such regulatory improvements. An important element of services trade negotiations should therefore be to create mechanisms to promote pro-competitive domestic regulatory reform and international regulatory cooperation.

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